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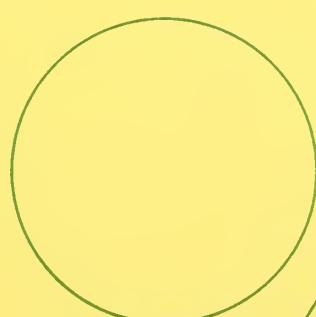
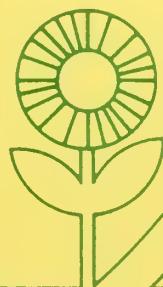
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FEDERAL TAXATION OF AND INCENTIVES FOR
FOREIGN INVESTMENT IN U.S. REAL ESTATE
AN INTRODUCTION
WITH EMPHASIS ON FARMLAND

April 1978

Donald Abramson
Karl Gertel
James A. Lewis

Natural Resource Economics Division
Resource Organization & Control
Economics, Statistics, and Cooperatives Service
U.S. Department of Agriculture
Washington, D.C. 20250

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ABSTRACT

The recent interest in U.S. farmland purchases by non-resident foreign investors evidences the attractiveness of U.S. farmland to foreign investors. One source of attraction reserved exclusively for foreign investors lies in tax provisions found in the United States Tax Code and in tax treaties between the United States and other countries. This paper explores how farmland opportunities which favor the non-resident foreign investor over the United States investor can arise for the non-resident alien individual and corporate investor in United States real estates, quantifies some of the incentives for foreign farmland purchases and discusses potential consequences for land tenure and land use.

FEDERAL TAXATION OF AND INCENTIVES FOR
FOREIGN INVESTMENT IN U.S. REAL ESTATE

by

Donald Abramson, Karl Gertel and James A. Lewis*

INTRODUCTION

This report is part of a larger study in which returns from absentee investment in farmland are compared to returns to common stock. This summary review of U.S. taxation of foreign investment with emphasis on farmland has been prepared as an interim report.

Examples from two nations have been selected for illustration:

- (1) West Germany, to describe the effects of a treaty allowing special treatment of real estate investment for tax purposes, and
- (2) Kuwait, to describe the situation in the absence of a treaty.

For each of these two nations we consider an individual investor, a corporation investing through a branch in the U.S. and a corporation investing through a subsidiary corporation incorporated in the United States. The tax rules for each category are summarized in appendix table 1. The incentives for foreign investment of these tax rules, and the implications for land tenure and land use in agriculture are discussed in the last section of the report.

*Abramson is a law student and book review editor of the George Washington School of Law Journal of International Law and Economics, formerly with the Natural Resource Economics Division; Economics, Statistics, and Cooperatives Service, U.S. Department of Agriculture. Gertel and Lewis are Agricultural Economists, Natural Resource Economics Division, Economics, Statistics and Cooperatives Service, U.S. Dept. of Agriculture.

Not covered in this report is an analysis of real estate investments from several other nations (e.g. Canada, France, Italy, Switzerland) with generally similar treaty provisions for taxing income from real estate. Use of tax havens whereby an investor from a non-treaty nation might benefit from the advantages of a tax treaty are briefly discussed. Other investment vehicles such as U.S. or foreign trusts and various types of partnerships are not covered. The purpose of this report is not to provide an exhaustive list of all possibilities. It is to give the policy maker and general reader an overview of the type of advantages enjoyed by the foreign investor in U.S. farmland and some appraisal of the economic consequences.

THE NON-RESIDENT FOREIGN INDIVIDUAL INVESTOR

Taxation in the Absence of a Treaty

Income from investment versus income from a trade or business

The federal income tax provisions applicable to the foreign owner of real estate operating in an individual capacity depend upon whether the foreigner is determined for tax purposes to be engaged in the conduct of a U.S. trade or business or acting merely as a passive investor.

In the absence of a treaty, the Internal Revenue Service (IRS) requires a withholding tax of 30% on certain items of gross income derived from property owned by a non-resident foreigner if it is ruled to be an investment. 1/ No deductions are allowed for expenses such as interest payments or depreciation on capital outlays incurred in the production of the income even if those expenses are so large that there might be no net income. 2/

However, income which is effectively connected with a U.S. trade or business is taxed according to the standard U.S. tax rates regardless of the nationality of the income recipient. Therefore, income will be taxed not on a gross basis but on a net income basis stemming from U.S. based activities only, with deductions for ordinary and necessary business

1/ U.S. Department of Commerce. Foreign Direct Investment in the United States, Vol. 6, Appendix J, Taxation, April 1976, p. 23.

2/ Internal Revenue Code §873(a). Expenses of a lessor which are paid by a lessee constitute additional rental income of the lessor and are thus subject to the 30 percent tax. Rev. Rul. 73-522.

expenses. The graduated tax scale applies to an individual's effectively connected trade or business income with the potential to range from negative taxation (tax savings if losses occur which are used to offset taxable income) to a 70% tax at the highest taxable income bracket.

An important difference between the taxation of investment and business income concerns the treatment of capital gains. If the foreigner's purchase is considered an investment, no tax upon any gain from the sale or other disposition of the property is imposed as long as the foreigner is in the U.S. for less than 183 days of the taxable year. 3/ However if the foreigner's purchase is determined to be related to engagement in a U.S. trade or business (e.g., if an individual purchased land so that he could farm the land and sell its produce), any gain from the eventual sale of the land will be subject to a U.S. capital gains tax. 4/

3/ U.S. Dept. of Commerce, Foreign Direct Investment in the U.S., op cit. p. 95(4).

4/ Ibid., p. 95(1). To qualify for long term capital gain treatment, the real estate must be considered a capital asset. Real estate will be considered to be a capital asset unless the taxpayer involved in the real estate transaction is determined to be a "dealer"--one who engages in the particular occupation of buying and selling real estate. Profits from dealer property are treated as ordinary income. The typical non-resident foreigner investing in farmland, who participates in only a small number of real estate transactions (even though the transactions may involve large acreage) and holds onto the land for extended periods of time without subdividing it, should be able to avoid "dealer" status.

What type of real estate activity constitutes being engaged in a U.S. trade or business? A 1973 ruling by the IRS (Rev. Rul. 73-522) dealt with the "net lease" situation where the taxpayer owned rental property in the United States. The property was leased on a long term basis and the lessee paid a monthly rental plus all operating expenses, repairs, real estate taxes, mortgage interest and principal, and property insurance. The foreign investor came to the United States one time for a week to supervise new leasing negotiations, draft documents, and make phone calls. The IRS concluded that this particular individual was not engaged in a trade or business within the United States. However, the ruling and related court cases imply that while the negotiation of a lease does not constitute being engaged in a trade or business, any considerable, continuous, and regular activity beyond negotiation, receipt of rent, and payment of expenses would constitute engaging in a trade or business. Activities conducted by the foreigner or his agent limited to lease negotiation, collection of rent and payment of expenses are likely to escape classification as a U.S. trade or business. 5/

Although the IRS has not laid down a firm rule on the distinction between investment versus business status, the more limited the management function of the foreign investor or his agent, the more likely "investor" status will not be challenged or refuted. The nature of the rental

5/ M. Abrutyn, "U.S. Real Estate and the Foreign Investor", the International Tax Report, April 29, 1975, p. 4.

agreement between the foreigner and the tenant will also affect investor status. A cash rental agreement in which the tenant pays a fixed dollar amount to the owner and also assumes all operating expenses, real estate taxes, insurance premiums, and mortgage payments, will very likely characterize the owner as an investor. A crop share arrangement in which the owner and tenant participate in the risks and rewards of the agricultural enterprise will tend to classify the owner of the farm as one engaging in a trade or business. 6/ Yet it must be stressed that the IRS proceeds on a case by case basis in analyzing the status of the property owner. 7/

The real property election.

The nonresident foreigner who is deemed to be an investor in real estate does have an alternative to the 30% tax on gross income. A special provision of the U.S. Tax Code, §871(d), pertaining only to real estate investment, allows the nonresident alien investor to elect to be taxed on the real property income as if he were engaged in a trade or business, and thereby be taxed at ordinary graduated rates on a rent income basis rather than on a gross income bases. 8/ The election applies to all real estate owned by the person making the election and cannot be made selectively for certain parcels of land (unless these parcels are insulated through the employment of a corporate ownership device).

6/ Telephone interview with Harold Oppenheimer, Chairman of Oppenheimer Industries agricultural management service. August 4, 1977.

7/ Telephone interviews with Steve Hannes, U.S. Dept. of Treasury, and with staff member of Office of International Operations, IRS, July 27, 1977.

8/ Foreign Direct Investment in the U.S., p. 254, op cit. There is no election which permits a trade or business to be treated as an investment.

Once the election to be treated as an ordinary business and taxed at graduated rates is made by the individual, it generally cannot be revoked unless the IRS consents to the revocation. In the absence of IRS consent allowing revocation of the election, the taxpayer must continually be treated under the ordinary domestic tax provisions. If the IRS would give its consent (a rare occurrence), the gross income taxation method would apply again. 9/

The usual disadvantage in making the election concerns the treatment of capital gains upon sale or other disposition. Before the election to be treated as if engaging in a trade or business in the U.S. was made, the individual investor may not have been taxed by the U.S. on any capital gains. After the election is made, the usual tax on gains is imposed on the individual. The investor has the flexibility to choose either taxing method and must balance the advantage of being treated as a investor and possibly paying no U.S. tax on capital gains against the corresponding disadvantage of being taxed on gross income even if there is little or no income after all expenses are deducted.

The case of Kuwait.

The foreign investor from Kuwait (and from any other country without a tax treaty with the U.S.) has the option to be taxed as an investor at the 30% rate on gross income without any tax on capital gains or taxed as if engaged in business at regular U.S. rates on net income and capital gains. The election to be taxed as if engaged in business is not revocable

9/ Zagaris, Bruce, Investment by Non-Resident Aliens in U.S. Real Estate. University of Miami Law Review, Vol. 31, No. 3, Spring 1977, p. 581.
However, treaties greatly reduce or eliminate the difficulties in revocation and can prove very advantageous to the taxpayer. See, e.g. Article 7 of the Germany-United States Tax Treaty, Vol. 16, U.S. Treaties 1882.

at will. Kuwait is unusual in that it does not impose any tax on an individual's income so U.S. taxation is the sole concern.

Taxation Under Treaty Provisions

One of the most important ways in which some treaties modify the tax provisions applicable to non-resident investors is the opportunity for the investor to switch yearly between treatment as an investor and treatment as one engaged in a U.S. trade or business. 10/

The case of West Germany

The U.S. Tax treaty with Germany provides the opportunity for a German investor in real estate to produce higher after-tax rates of return than a United States investor faced with an identical pre-tax rate of return. A German investor who has substantial expenses from operations, depreciation, and interest could elect to be treated as engaging in a U.S. trade or business and be taxed by the U.S. on income after deducting expenses. It is possible for him to claim losses after expenses which can be used to offset other U.S. income. Germany does not tax this income due to the tax treaty. The German investor who elects to be taxed on a net income basis has a good chance of reverting to be taxed as a passive investor in subsequent years. 11/ Thus the capital gain will be free from German tax as well as from the U.S. tax since Germany does not impose any

10/ In all tax treaty matters, the United States permits the foreign investor to choose between the treaty provisions and the United States Tax Code and select the most favorable alternative. Foreign Direct Investment in the U.S. op cit. p.157.

11/ IRS has not published a position on whether the real property election under the German Treaty can be revoked without the permission of the Commissioner of Internal Revenue Service. IRS has so ruled for the Canadian and French treaties (Rev. Rul. 77-174), which have language concerning the real property election similar to that of the German treaty.

tax on capital gains in non-business property if held for more than two years. 12/ Therefore, the German investor often possesses the advantage of escaping from all capital gains taxes and does not relinquish the privilege of being treated identically with U.S. taxpayers in other aspects.

All nonresident aliens, irrespective of country, are denied the opportunity available to many U.S. investors and businessmen to elect to be treated as a Small Business Corporation under Subchapter S of the U.S. Tax Code §§1371-1379. Stockholders in Subchapter S corporations are allowed to partake of several institutional advantages inherent in the corporate entity such as limited liability, free transferability of property interests, and centralization of management yet avoid the double taxation imposed on the income flowing to the usual corporate investor. The income from the Subchapter S corporation will be taxed not at the corporate level but only as a part of the shareholder's income (except in special situations specified in §1378 of the U.S. Tax Code). Although there are countervailing limitations which can offset Subchapter S advantages--e.g., a shareholder may not claim any deductions in excess of the amount contributed or loaned to the corporation so that tax shelter features are curtailed, the election of Subchapter S status has been popular.

For the domestic investor who purchases and rents out farmland the Subchapter S corporation is of limited advantage. If more than 20 percent of the corporate income is passive income, such as rent, the exemption from corporate taxes is not available.

12/ op cit. p. 95(4). Also Bureau of National Affairs Tax Management Portfolio: Business Opportunities in West Germany, p. A-54.

THE FOREIGN INVESTOR AS A CORPORATION

The foreign investor might employ two different types of corporate devices for real estate investment in the United States. The first type of corporation has its place of incorporation outside of the United States and derives income through a branch within the United States. The second type of corporation is incorporated in the United States and is a subsidiary of the foreign corporation. In both types, the foreign individual investor receives dividends and capital gains or losses on stockholdings attributable ultimately to U.S. real estate transactions. Kuwait provides an example of a country with no tax treaty with the United States and Germany represents a country with a U.S. tax treaty.

The case of Kuwait

Investment through a branch: One possibility for corporate ownership of U.S. real estate would be for a Kuwaiti corporation to establish a branch in the United States which functions solely as an investment vehicle. If the branch does not engage in a trade or business, but invests in real estate only, the choice of how the parent corporation wishes to be treated for tax purposes is available (§882(d) of the U.S. Tax Code) just as it was available for the individual investor to choose. If the corporation declines to elect to be treated as if it were engaging in a trade or business, gross rental income from U.S. will be subjected to the 30% withholding tax, but capital gains will not be taxed by the U.S. 13/

13/ Direct Foreign Investment in the U.S. op. cit p. 97.

If the corporation elects to be treated as if engaging in a trade or business, net rental income will be taxed at ordinary U.S. tax rates. 14/ The corporation incurs no penalty due to its foreign incorporation unless more than 50% of the gross income of the entire corporation is effectively connected with the conduct of a trade or business in the United States. If more than 50% of the foreign corporation's gross income is so effectively connected, a 30% withholding tax is imposed on that share of dividends and interest paid by the foreign corporation which derive from earnings attributable to business in the U.S. This tax is on the shareholders receiving the dividends or on the creditors receiving the interest and is satisfied by the withholdings. It is separate from the tax imposed on the corporation.

Subsidiary incorporated in U.S. The other possibility for corporate ownership of U.S. real estate involves the use of a subsidiary incorporated in the United States owned by a Kuwaiti corporation. Ordinary U.S. corporate tax rates will apply to the subsidiary corporation, but 30% of the dividends from the subsidiary will be withheld for U.S. taxes. 15/ However both withholding taxes on dividends and capital gains taxes from a U.S. subsidiary of a foreign corporation can be avoided or minimized. Devices for this purpose include the sale of stock in the subsidiary by the parent corporation or liquidation of the subsidiary by the parent corporation. However, these methods have some risk, e.g., penalty taxes may be imposed if profits are accumulated in lieu of dividend payments. 16/

14/ A 20% tax is imposed on the first \$25,000 of net income, a 22% tax is imposed on the next \$25,000 and a 48% tax is imposed on income beyond \$50,000. A 30% maximum tax rate on long-term capital gains will be imposed. Foreign Direct Investment in the U.S. op cit. p. 15.

15/ Op cit. p. 23.

16/ Forry, John I., Planning Investments from Abroad in U.S. Real Estate. International Lawyer, Vol. 9, No. 2, 1975, pp. 245-247.

Whether investing through a branch or a subsidiary incorporated in the United States, the Kuwaiti investor needs to consider only U.S. taxes since Kuwait imposes no taxes on income derived outside its borders. 17/

The case of West Germany

Germany has a tax treaty with the United States which provides attractive opportunities for the German corporation creating a branch that invests in U.S. real estate, but is not considered to be engaging in a trade or business. 18/ The treaty also reduces the tax liabilities for the German corporation with a subsidiary incorporated in the United States.

Investment through a branch. A German corporation establishing a U.S. branch that possesses the characteristics of an investor in the United States is permitted to elect to be treated as if it had real property income that is effectively connected with a trade or business in the U.S. for any taxable year, just as a German individual investor is permitted an election yearly. 19/ The gross rentals received by the branch will be taxed at the 30% rate and capital gains will not be taxed in the U.S. if the election to be treated as a business is declined. If the election to be treated as a trade or business is made, net rental income and capital gains will be taxed at the ordinary U.S. corporate rates with a maximum of 48% on income and 30% on capital gains. 20/

17/ Foreign Direct Investment in the U.S. op cit. p. 226.

18/ United States--Federal Republic of Germany Income Tax Convention 5 U.S.T. 2768, TIAS No. 3133, as modified by Protocol, 16 U.S.T. 1875, TIAS No. 5920.

19/ Article 9 of the treaty and Article 7 of the Protocol.

20/ Foreign Direct Investment in the U.S. op cit., p. 254, 255.

Whether the election is made or not, there will be no taxation of annual corporate income from the U.S. branch by Germany. Dividends paid by the German parent corporation to German shareholders who are not U.S. residents will be exempt from U.S. taxes but subject to German taxes. 21/

Like the individual German investor, the German Corporation often has the advantage of escaping from all capital gains taxes while not relinquishing the privilege of being treated identically to U.S. corporations in other respects. However unlike the situation favorable to the individual German investor, Germany will impose its ordinary income tax on capital gains earned by the corporation if such gains are not taxed in the U.S. 22/ The German Corporation can claim ordinary and capital losses in the U.S. to offset domestic income earned in Germany even though profits from the U.S. branch would be exempt from German taxation

21/ U.S. Federal Republic of Germany Income Tax Convention, 5 U.S.T. 2768, TIAS No. 3133, Article 14.

22/ The German U.S. Treaty gives the United States the right to tax foreign real estate investment within its borders. The U.S. Treasury Model Tax Treaty has a similar provision (Commerce Clearing House Tax Treaties, May 17, 1977, p. 154). The general view is that the U.S. has primary but not exclusive right to tax foreign real estate investment within its borders. Therefore the investors' home country is free to tax income from real estate in the U.S. earned by the investor to the extent that the U.S. has imposed no tax. However a number of U.S. treaties, e.g. with Iceland, Japan, Norway contain a provision allowing only the situs country to tax real property income.

under the treaty. 23/

Subsidiary incorporated in the United States. Ordinary U.S. corporate tax rates apply to the income of the U.S. subsidiary. If a German company owns 25% or more of the voting shares of the U.S. corporation, the dividends from the subsidiary will be subject to a 15% rather than a 30% U.S. withholding tax and will be exempt from all German taxation because of the treaty between Germany and U.S. 24/

The possibility for softening the impact of a graduated tax scale arises when a German corporation sets up a U.S. branch or U.S. subsidiary and also when a German individual invests in U.S. farmland which yields moderate net income. (Many other treaty countries provide similar situations). The income splitting possibilities for the German individual and for the corporate branch or subsidiary located in the U.S. occur because income earned in the U.S. is exempt from German taxation

23/ Foreign Direct Investment in the U.S. op cit. pp. 193-196. If losses from U.S. operations are claimed to offset German income then profits from U.S. operations in subsequent years are taxed by Germany up to the amount of U.S. losses claimed. Thus losses from U.S. operations can be used to defer taxes on German domestic income.

24/ Ibid. p. 166. If the German Corporation owns less than 25 percent of the voting shares, the dividends are not exempt in Germany, but a tax credit for the 15% U.S. withholding tax is premitted. The United States may impose a 25% withholding tax if the German parent company reinvests in the dividends in its U.S. subsidiary. Foreign Direct Investment in the U.S., p. 60.

due to the tax treaty. 25/ Income from Germany is not combined with U.S. income so each country's taxing authority has a lower amount of income upon which to levy the income tax. Corporations serve as income splitting devices because they are treated as separate entities by both countries and therefore will be taxed separately.

Use of third country as tax shelter.

A foreign national of a country which has no treaty providing favored U.S. tax treatment may invest in the United States through a corporation of a third country which has such a treaty as well as low corporate and dividend taxes of its own with regard to U.S. real estate investment. The Netherland Antilles is one example of a third country which has attracted considerable capital from other countries for the purpose of investing in U.S. real estate. 26/ However this investment route is not simple or without risk. For example, if the foreign investor's contacts with the treaty country are minimal the advantages of the tax treaty may be denied. "Even though sophisticated investors from non-treaty countries who are willing to accept complexity and incur costs and risks can reduce the burden of the 30 percent U.S. withholding tax through a treaty between the United States and another country, there are many potential foreign investors who are not willing to do that. Some invest anyway and pay whatever U.S. taxes are imposed upon investments made without a treaty.

25/ Foreign Direct Investment in the U.S., op cit. p. 154.

26/ Forry, op cit., pp. 247-249, also Zagaris, Bruce, Investment of Non-Resident Aliens in U.S. Real Estate, op cit. Spring 1977, pp. 604-607.



Others just do not invest in the United States because of the 30 percent tax."27/

The foreign government corporation.

Under §892 of the U.S. Internal Revenue Code, certain income of foreign governments within the United States is exempt from Federal income taxes. Corporations formed by foreign governments are tax exempt provided that U.S. income derives from passive investments and net income from the corporation does not accrue to the benefit of private persons. 28/ The extent of immunity from U.S. taxes by entities formed by foreign governments will be further clarified in new IRS guidelines expected in 1978.

SOME ECONOMIC IMPLICATIONS

Tax incentives for foreign acquisition of U.S. farmland

The question addressed in this section and elaborated in appendix 2 is the extent to which the special provisions for taxing foreign investment in real estate provide incentives for foreign investment in farmland. The question is examined for the individual investor, and some tentative judgments are made for the corporate investor.

It is clear that the tax provisions offer some incentive for foreign investment in U.S. farmland. However the important question is how strong is this incentive? We estimate the incentive in terms of how much more the individual foreign investor who is not "effectively connected" with a U.S. trade or business is willing to pay for farmland because he is exempt from the capital gains tax.

27/ Foreign Direct Investment in the U.S., op cit. p. 69.

28/ Rev. Rul. 75-298, 1975-2 C.B. 290.

The calculations in appendix 2 clearly indicate that the incentive of the exemption from the capital gains tax will vary widely depending on the investors' anticipation of future appreciation of farmland prices, [the rate at which he discounts future appreciation of farmland prices], the rate at which he discounts future income, how long he plans to hold his farmland investment, and his expected taxable income in the year of sale.

Using plausible combinations of the above variables, estimates are provided in appendix 2. For a large investor whose capital gains would place him in a 60 percent tax bracket for ordinary U.S. income and a 30 percent effective bracket on capital gains, the incentive would range from about 12 to 15 percent if he expects farmland to appreciate at the rate of 8 percent per year. This calculation assumes a 10 percent discount rate on future income. The implication is that the foreign investor would be willing to pay 12 to 15 percent more for farmland as a result of the capital gains tax exemption. The incentive would be no more than 9 percent if he expects farmland value to appreciate at 6 percent per year and it could be as high as 24 percent if he expects farmland to appreciate at an average rate of 10 percent over a 20 year period, and expects to be in a high tax bracket.

For the investor from a non-treaty country the incentive of the capital gains tax exemption will generally be offset or more than offset by the disincentive of the 30 percent tax on annual gross income. Only for the large investor who expects a long time period in which farmland appreciates at a rate of 10 percent or more do the tax provisions provide an incentive to pay more for farmland. For example, with anticipated

land appreciation averaging 10 percent over a 10 year period, a large scale investor with a discount rate of 10 percent would pay about 5 percent more for farmland.

For the investor from a treaty nation the disincentive of the 30 percent gross income tax may not apply. Nevertheless the investor from a treaty nation will incur some disincentive which can be described but not quantified. To maintain this status as a passive investor, the foreign investor can not enter a share lease agreement which yields probably higher but more uncertain returns (see p. 5) His cash lease must be carefully drawn to avoid the status of "effectively connected" with a U.S. trade or business. While the lease can probably contain a hedge against inflation by indexing the cash rent or a general cost of living index, frequent changes in lease terms, lands leased, or tenants may disqualify the investor from the capital exemption. 29/

In summary, the incentive for investment in U.S. farmland that the tax regulations provide for the individual foreign investor vary with the expectations and circumstances of the investor. They can be substantial, especially in periods of sharply rising farmland prices and optimistic expectations of future farmland appreciation. However tax incentives are only one of the several reasons why citizens of other countries may

29/ Based on discussions with staff members of the Office of International Operations of IRS. An advance ruling on the eligibility of the leasing arrangement for "not being effectively connected" with a U.S. trade or business may be obtained from IRS. However IRS can not guarantee against future adverse rulings from future activities not evident in the leasing arrangements.

wish to purchase U.S. farmland. Other reasons are diversification of investments, the security of farmland investment, the stability of annual returns and the favorable price of U.S. farmland compared to farmland prices in Western Europe and Japan, reinforced in recent years by more favorable currency exchange rates for some foreign investors. An analysis of the incentives for farmland investment provided by the tax rules applicable to the foreign corporate investor is beyond the scope of this study. However some statements can be made.

The foreign corporation with a U.S. branch investing in real estate enjoys the same exemption from capital gains taxes as the individual private investor provided the branch is ruled to be "not effectively connected" with a U.S. trade or business. However in the case of West Germany, the advantage of exemption from the U.S. capital gains tax is offset by home country taxation. West Germany will tax capital gains of a branch of a German corporation but exempt the individual investor from such a tax. Kuwait will impose no taxes on U.S. earnings by a Kuwaiti Corporation or individual investor but since Kuwait is a non-treaty nation the incentive of exemption from capital gains taxes would be offset or diminished by a 30 percent tax on gross income. Thus the tax incentive of investing in farmland through a branch of a foreign corporation depends on tax provisions in the home country of the corporation and on whether a treaty exists between the U.S. and the home country. The attraction of the Netherland Antilles as a home country for corporations investing in U.S. real estate is a combination of tax treaty with the U.S. and no Netherland Antilles taxes on income from U.S. real estate.

Considerable tax incentives for investing in farmland are available to a U.S. incorporated subsidiary of a foreign corporation. While the subsidiary will be taxed at U.S. corporate rates, and dividends paid to

foreign investors are taxed at 30 percent, treaty provisions reduce tax on dividends to 5 or 15 percent. Moreover, taxes on dividends and capital gains can be avoided or minimized through sale of stock of the subsidiary by the parent corporation or liquidation of the subsidiary.

Land tenure and land use

Two noted land economists, Folke Dovring and Mason Gaffney have suggested that absentee ownership by non-resident aliens carries the potential of less intensive land use. 30/ This would lead to decreased employment opportunities for non-land factors of production, especially labor.

Reasoning from a priori grounds, both authors conclude that maximization of returns from land by an absentee owner, whose management is limited by time and distance, would lead to a smaller gross farm product and less use of labor than would result if the farm were run by an owner-operator who employs his own labor and attends full time to the farm enterprise.

Gaffney also gives empirical evidence. He cites the U.S. Census of Agriculture of 1900 which shows a systematic increase in size of farm as the distance between farm and owner increases. At the same time intensity of use declined with size of farm. He also lists other references the most recent of which is date 1953. We can only repeat Gaffney's remark that the vintage of these sources "testifies glowingly to the need for more recent information."

30/ Folke Dovring, Economic Impact of Foreign Investment in Real Estate, pp. 132-146, Mason Gaffney, Social and Economic Impacts of Foreign Investment in U.S. Land, pp. 147-163. Both in Foreign Investment in U.S. Real Estate, Economic Research Service, USDA, 1976.

The reasoning of Dovring and Gaffney assumes that land use is determined by the foreign landowner. As we have seen, the exemption from the capital gains tax of the foreign individual and corporate branch investor depends on not being effectively connected with the landed enterprise. This requires that the land be leased on a cash rent basis with decisions on how to farm the land being left to the tenant. Foreign investment in farmland is thus conducive to tenancy with a particular type of lease, a cash lease rather than a share lease in which returns and expenses are shared between landlord and tenant. 31/

A popular vehicle for foreign investment is the U.S. corporation. This form of investment offers possibilities of avoiding capital gains and reduced taxes on dividends by foreign shareholders from treaty nations without the strictures on active management by the owner. Thus foreign investment in agricultural land is conducive to corporate farm ownership. The corporation may lease land to tenants, or engage in farming directly by employing a full time manager or using a farm management company. In the latter two cases the locus of decision on intensity of land use is made by the foreign investor or his agent and the priori arguments of Dovring and Gaffney apply.

31/ The head of a leading firm engaged in sales of farmland to foreign investors related to the author that, when feasible, he recommends a net cash lease for his clients. However share leases and even custom farming are utilized in some cases. In Iowa, where share leases are predominant, 5 out of 8 known leasing arrangements on foreign owned farmland were cash leases. Currie, Craig, et al. Foreign Investment in Iowa Farmland in Foreign Investment in U.S. Real Estate, ERS, USDA, 1976.

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What are the implications of tenant and corporate farming for land use? As best we can judge they are a tendency towards less intensive use, induced in part by larger farms. Let us briefly review the evidence.

The U.S. census of agriculture consistently shows both tenant operated farms and farms operated by owners who rent a portion of the units they operate to be larger in land area than farms entirely owned by the operator. The largest farm size is for farms operated by managers.

Detailed studies of differences between owner-operated and tenant-operated farms in the cornbelt were made by Miller, Chryst and Ottoson, and by Hurlburt. 32/ In terms of efficiency, assuming market prices for all products and inputs including the farmer's own labor, no significant difference could be found between the tenure types. However, both studies report a larger average land area for tenant operated farms and a smaller gross product per acre. 33/

32/ Miller, Walter G.; Chryst, Walter E.; and Ottoson, Howard W., Relative Efficiencies of Farm Tenure Classes in Intrafirm Resource Allocation. Research Bul. 461, Iowa State College, Nov. 1958. Hurlburt, Virgil L., Use of Farm Resources as Conditioned by Tenure Arrangements, Univ. of Neb., College of Agriculture, Research Bul. 215, April 1964.

33/ The results reported by Miller et al. and by Hurlburt are primarily for farms rented on crop shares but we believe the finding would be similar for farms rented solely for cash. It has been argued that share leasing is less conducive to intensive land use than owner operatorship or cash leasing because the share lease tenant furnishes all the labor and equipment but receives only a portion of the crop. Against this must be set the interest of the share-landlord in maximization of the gross product of the land and the share landlord's contribution towards production costs. Hurlburt states (p. 29, op cit) "Tenant and owner operator follow essentially the same farming practices for the same size of business."

Thus, under conditions of plentiful employment opportunities and mobility of labor the research does not show any advantage for a particular type of land tenure. If alternative employment opportunities are scarce, and labor can not easily move out of agriculture, the advantage lies with owner operations.

Finally we wish to stress research needs. Our assessment of the consequences for tenure and land use of foreign investment in farmland under U.S. tax laws is based on a priori reasoning combined with limited evidence, it is a hypothesis. We suggest investigations of the following questions for a firmer assessment and basis for policy decisions:

a) What is the extent and location of foreign ownership of land?

The answer to this issue will give some idea of the significance of the issue although it should not be the sole criterion.

b) Why do foreigners invest in U.S. farmland? How long do they plan to keep the land? and what are their expectations of annual returns and capital gains?

c) Under what type of ownership is the foreign investment held, individual, corporate, trust, etc.? Is the land operated by the owner or is it rented for cash or for shares of the product? Does the locus of land use decisions lie with the owner, his agent, or his tenant? Answers to these questions will indicate if the investment is eligible for various tax advantages if combined with country of residence of the owner.

d) Do farm sizes and farm operations owned by foreign investors differ significantly from those of U.S. owned farms in the same area?

Regrettably we can not turn to a ready list of foreign land investors; foreign ownership can take a variety of forms, many of which are not easily identified as foreign. The challenge lies in coming up with carefully structured and reasonably priced methods of finding answers in which some confidence can be placed.

Appendix 1.--U.S. and home country taxation of the individual and corporate investor from Kuwait and West Germany

| Country : | Individual investor : | Corporation with U.S. branch : | Corporation with subsidiary Incorporated in U.S. |
|-------------------------------------|--|--|---|
| <u>Investment considered by IRS</u> | | | |
| : | <u>a passive investment</u> in active business <u>1/</u> | <u>a passive investment</u> on active business <u>1/</u> | |
| : | A Thirty percent of gross income withheld <u>2/</u> | A Thirty percent of gross income withheld <u>2/</u> | Net income <u>3/</u> and capital gains <u>4/</u> of subsidiary taxed at U.S. corporate rates |
| : | for income, <u>3/</u> capital gains, <u>4/</u> estate and gift taxes | at U.S. corporate rates | Dividends subject to 30 percent withholding tax <u>7/</u> |
| U.S. | No capital gains tax, subject to estate and gift tax, | No tax on capital gains No tax on dividends <u>6/</u> | No tax on dividends <u>6/</u> |
| | or | or | |
| | B Elect to be taxed as active business | B Elect to be taxed as if active business | |
| Kuwait taxes | None | None | None |
| Germany U.S. taxes | A or B as above but with potentially greater flexibility for reverting to A after choosing B | A or B as above but with potentially greater flexibility for reverting to A after choosing B | Same as Kuwait with potentially greater flexibility for reverting to A after choosing B |
| German Taxes | None <u>5/</u> | None | Dividends taxed-Capital gains taxed if not taxed in U.S. Branch losses creditable against income of German parent company |

1/ A U.S. trade or business or effectively connected with a U.S. trade or business, see pp. 5.6 for discussion.

2/ In determining gross income, local taxes, maintenance, and other expenses incidental to the investment are not deductible even if paid by a tenant.

3/ Taxable income includes income stemming from U.S. based activities only.

4/ Taxable capital gains can be avoided or minimized by exchange for like property. This device is also available to U.S. investors.

5/ Property must be held more than two years to avoid German tax on capital gains.

6/ In the case of Kuwait, dividends are tax exempt unless more than 50 percent of the gross income of the Corporation is effectively connected with a U.S. trade or business.

7/ Foreign corporation may avoid or minimize capital gains taxes and withholding taxes on dividends through sale of stock in a U.S. subsidiary by a foreign corporation or liquidation of the subsidiary certain requirements are met. In this case Germany may tax capital gains when repatriated.

APPENDIX 2 - ESTIMATES OF TAX INCENTIVES FOR THE INDIVIDUAL
FOREIGN INVESTOR

The Present Worth of Exemption from Tax on Capital Gains

The model used in this analysis assumes an investor who is security minded, interested in a relatively long term investment, well informed, and interested in productive land used for cash crops or ranching, 1/ The foreign investor is further assumed to examine historical data on farmland appreciation and rental income in the United States as a whole and in particular regions before making a judgment about the future. We have summarized such information in table 1 for the United States and four farming regions of potential interest to foreign investors. 2/ The

1/ Paulsen, Arnold, Goals and Characteristics of Foreign Purchasers of Farmland in the U.S. Also Currie, Craig et. al. Foreign Investment in Iowa Farmland, p. 124. Both in Foreign Investment in U.S. Real Estate, Economic Research Service, USDA 1976.

2/ Illinois and Mississippi for which land values are displayed in table 1 are among the 12 states which prohibit or have major limitations on foreign landownership. Illinois limits individual (but not corporate) foreign landownership to six years. Mississippi prohibits individual (but not corporate) alien landownership except by way of security for a debt. The data for Illinois and Mississippi are shown to provide a basis for anticipating returns for cash crop areas of the cornbelt and the Mississippi Delta, rather than for specific states. State prohibitions and limitations on alien landownership can be avoided by a variety of legal methods. They may however present some risk and expense, especially for the foreign investor who wishes to avail himself of the potential tax advantages available to foreign investors. For details see Foreign Direct Investment in the U.S. op cit. Vol. 8, Appendix M., Land Law.

Table 1.--Value per acre and annual rates of appreciation of farmland.

| Period | All U.S. | <u>Farms and grazing land rented for cash</u> | | | |
|-------------|--|---|----------------|----------------|----------------|
| | farm | Central Kans. | Central Ill. | Upper Miss. | Montana |
| | real estate | wheat 1/ | cash grain 2/ | Delta 3/ | grazing 4/ |
| | : | : | : | : | : |
| Years | <u>dollars</u> | <u>dollars</u> | <u>dollars</u> | <u>dollars</u> | <u>dollars</u> |
| Spring 1977 | 456 | 402 | 2513 | 658 | 98 |
| Spring 1967 | 161 | 173 | 655 | 333 | 30 |
| Spring 1957 | 93 | 118 | 379 | 147 | 15 |
| | | | | | |
| | <u>Compound annual rate of appreciation 5/</u> | | | | |
| | <u>percent</u> | <u>percent</u> | <u>percent</u> | <u>percent</u> | <u>percent</u> |
| 1967-1977 | 11.0 | 9.0 | 14.5 | 7.0 | 12.5 |
| 1957-1967 | 5.5 | 4.0 | 5.5 | 8.5 | 7.0 |
| 1957-1977 | 8.0 | 6.5 | 10.0 | 8.0 | 10.0 |
| | | | | | |

1/ Crop Reporting District 5, Central Kansas

2/ Crop Reporting District 6, Central Illinois. For restrictions on alien land ownership in Illinois, see appendix footnote 2.

3/ Crop Reporting District 1, Northwest Mississippi. For restriction on alien land ownership in Mississippi, see appendix footnote 2.

4/ State of Montana except for crop Reporting District 1, Northwest Montana, where value and rentals of grazing land are affected by recreational demand and not typical of the rest of the State.

5/ Rounded to the nearest half percent.

Sources: U.S. farm real estate. Farm Real Estate Market Developments, CD-81, July 1976 and Supplement No. 2, March 1977, Economic Research Service, USDA. Farmland rented for cash, annual surveys conducted by the Economics, Statistics, and Cooperatives Service, U.S. Department of Agriculture

land appreciation for 1967-1977 ranged from 7 to over 14 percent per year. The conservative investor is unlikely to count on such favorable rates in the long term future. He will look at earlier periods when real farm income and farmland appreciation were generally lower. Considering the 20 year period 1957 to 1977, the anticipated future rates of land appreciation of most foreign investors, is likely to be covered by a range of 6 to 10 percent.

The present worth of future appreciation of the land investment will depend on the investor's rate of discount. For the security-minded investor this rate should be at least as high as the rate at which he can borrow funds secured by a farm mortgage. We assume a discount rate of 10 percent, somewhat higher than the mid-1977 rate on farm mortgage loans made by life insurance companies.

If the foreign investor is not exempt from the capital gains tax, the present value of the expected capital gains will be reduced by the amount of the capital gains tax. The amount of the reduction will depend on the investor's income taxable by the U.S. in the year the land is sold. Taxable income could be quite high even if the foreign investor's sole U.S. based income is capital gains from farmland investment. For example, with an annual appreciation rate of 6 percent, capital gains, before land selling costs, from an investment of \$100,000 would be \$79,000 after 10 years, and \$100,000 is only a fraction of the investment required if the investor wants to purchase an adequate size farm unit in a cash grain or ranching area. Allowing for a 50 percent reduction of long term capital gains permitted for reporting such gains as taxable income, joint ownership by husband and wife, and the possibility of spreading the sale over a number of years, we estimate a tax rate on capital gains, ranging from 10 to 30 percent.

Given the foreign investors anticipation of future farmland appreciation, his rate of discount and effective tax rate on long-term capital gains, the calculation of the present (discounted) worth of the capital gains tax is presented in table 2. 3/ We show the present worth of the capital gains tax per \$100 invested assuming a discount rate of 10 percent. The figures in table 2 give the percent by which an investor will reduce the purchase price for land because of the capital gains tax. Conversely, the figures also show how many percent more the investor would be willing to pay for farmland if he were exempt from the capital gains tax.

Even when confined by the range of our assumptions the present worth of the capital gains tax shows a wide range. If the investor discounts future income at 10 percent and anticipates average annual land appreciation

3/ The present worth of the capital gains tax is given by:

$$\frac{T \times [0.95 \times 100 (1 + r)^n - 100]}{(1 + i)^n}$$

where T is the proportion of capital gains payable as tax.

0.95 is the proportion of sales proceeds retained by the seller after payment of sales commission and other sales costs.

r is the annual rate of land appreciation

i is the rate of discount

n is the number of years the investment is held

The numerator of the above expression gives the amount of capital gains tax due on \$ 100 invested. Since this tax is due n years after the investment is made, the denominator discounts the tax payment to an equivalent present value, as of the time the investment is made. The quotient is the present value of the capital gains tax per \$100 invested. It is the percentage by which the investor will reduce the purchase price he bids for the land because of the capital gains tax.

at 8 percent the incentive will range from about \$4 to \$15 per hundred dollars invested. The interpretation of this result is that under the assumptions made, the foreign investor would be willing pay 4 to 15 percent more for farmland property because of the exemption from capital gains. The incentive would be ^{no}/more than 9 percent if the investor anticipates at 6 percent rate of land appreciation and could be as high as 24 percent if he expects farmland to appreciate at 10 percent over an investment period of 20 years.

Table 2. -- Present worth of the capital gains tax per \$100 invested in farmland, discounted at 10 percent. 1/

| Years land is held | <u>Average annual rate of appreciation in land values</u> | | |
|-----------------------|---|----------------|----------------|
| | 6 percent | 8 percent | 10 percent |
| | <u>dollars</u> | <u>dollars</u> | <u>dollars</u> |
| 10 | 2.7 - 8.1 | 4.1 - 12.2 | 5.6 - 16.9 |
| 15 | 3.1 - 9.2 | 4.8 - 14.5 | 7.1 - 21.3 |
| 20 | 3.0 - 9.1 | 5.1 - 15.3 | 8.0 - 24.0 |

1/ The low figure in each cell assumes an effective rate of Taxation of capital gain of 10 percent. The high figure assumes a 30 percent rate. See footnote 3 for method of calculation.

The Present Worth of Higher Taxation of Annual Rental Income

Offsetting the incentive of exemptions from capital gains is the disincentive of higher taxation of annual rental income. This disincentive does not apply to the investor from a treaty country who can choose to be taxed at U.S. rates on net income. It does apply to the investor from a non-treaty country. The latter must pay a 30 percent tax on gross income to obtain exemption from capital gains taxation.

Nevertheless the investor from a treaty nation who escapes the 30 percent gross income tax may incur some disincentives. These can be described but not quantified. To maintain this status as a passive investor eligible for the capital tax exemption he can not enter in a share lease agreement which would probably yield higher, but more variable net returns. Further the cash lease must be carefully drawn to maintain the investors passive status. Frequent changes of lease terms, tenants, or of land under lease is likely to disqualify the investor from the capital gains exemption.

The foreign investor from a non-treaty nation who wishes to avoid the capital gains tax must accept a 30 percent tax on annual gross income. The bottom line of table 3 gives the present worth of a 30 percent tax on gross income from 1967 to 1977 per \$100 invested. At a discount rate of 10 percent, the present worth of the 30 percent gross income tax paid by the investor from a non-treaty nation ranges from 11 to 15 percent of the amount invested. If the investor elects to be taxed on a net income basis, thereby foregoing the capital gains tax exemption, his annual taxes would be lower. They could well be zero since net income ranges from 4 to 7 percent of the amount invested while interest charges on a mortgage, which are deductible, are 9 to 10 percent.

Table 3. -- Average annual and present worth of gross and net cash rent and 30 percent tax of
rent per \$100 invested in 4 farming areas 1967-1977. 1/

| Item | Central Kans. wheat | Central Ill. cash grain | Upper Miss. Delta soybean-cotton | Montana grazing land |
|-----------------------------------|------------------------|----------------------------|-------------------------------------|-------------------------|
| | <u>dollars</u> | <u>dollars</u> | <u>dollars</u> | <u>dollars</u> |
| <u>Average annual</u> | | | | |
| gross rent | 7.3 | 7.7 | 8.4 | 6.8 |
| net rent <u>2/</u> | 4.5 | 5.0 | 6.7 | 4.1 |
| <u>Present worth of <u>3/</u></u> | | | | |
| gross rent | 42.5 | 44.4 | 49.5 | 37.3 |
| net rent | 26.0 | 28.7 | 39.8 | 22.2 |
| Thirty percent of gross rent | 12.8 | 13.3 | 14.9 | 11.2 |

1/ For location of farming areas see footnotes 1-4, table 1.

2/ Net cash income excluding depreciation but including some capital improvements and therefore close to net taxable income.

3/ Discounted at 10 percent

Sources: Gross rent from annual surveys of rented farms and western grazing land conducted by the Economics, Statistics, and Cooperatives Service, U.S. Department of Agriculture. Landowners costs extrapolated primarily from Cost and Returns on Commercial Farms, ERS, USDA, Stat. Bul. 297, 1961, Stat. Bul. 368, 1966, Ag. Info. Bul. 230 Revised Sept. 1963 and Farm Real Estate Taxes RET-15, ERS, USDA, 1976.

Comparing the 11 to 15 percent present worth of the gross income tax to the present worth of the capital gains tax (table 2), we conclude that for the individual investor in farmland from a non-treaty nation, the incentive of exemption from the capital gains tax is frequently neutralized by the 30 percent tax on gross income.

